GCR RATINGS

**Credit Rating Announcement**

# GCR maintains Santam Limited's ratings on Negative Outlook due to high uncertainty over contingent business interruption claims

## Rating action

Johannesburg, 18 December 2020 - GCR has affirmed Santam Limited's ("Santam") national scale financial strength rating of AAA$_{(ZA)}$ and international scale financial strength rating of BB+, with both ratings maintained on Negative Outlook. Furthermore, GCR has affirmed Santam's national scale long term issuer rating of AA+$_{(ZA)}$, with a Negative Outlook and also affirmed the national scale long term issue ratings of Santam's outstanding subordinated callable notes (Stock Codes SNT02, SNT03, SNT04) of AA-$_{(ZA)}$, with Negative Outlooks. GCR has also accorded a national scale long term issue rating of AA-$_{(ZA)}$ on the new subordinated callable note; SNT05, issued on 30 November 2020. The Outlook on the new note is Negative.

| Rated Entity / Issue | Rating class | Rating scale | Rating | Outlook/Watch |
|---|---|---|---|---|
| Santam Limited | Financial strength | National | AAA$_{(ZA)}$ | Negative Outlook |
| | Financial strength | International | BB+ | Negative Outlook |
| | Long term issuer | National | AA+$_{(ZA)}$ | Negative Outlook |
| SNT02 | Long term issue | National | AA-$_{(ZA)}$ | Negative Outlook |
| SNT03 | | | AA-$_{(ZA)}$ | Negative Outlook |
| SNT04 | | | AA-$_{(ZA)}$ | Negative Outlook |
| SNT05 | | | AA-$_{(ZA)}$ | Negative Outlook |

## Rating rationale

The ratings for Santam (comprising Santam Limited and its subsidiaries) have been maintained on Negative Outlook reflecting continued risks emanating from the strained operating environment, most specifically the potential reduction in the financial profile in the wake of the COVID-19 pandemic. Relatedly, the November High Court ruling on policies with a contingent business interruption ("CBI") extension was in favour of policyholders, with Santam applying for leave to appeal the judgement, while concurrently increasing reserves on respective CBI claims to R3bn in 11M F20, from R1.3bn at 1H F20. GCR considers uncertainty over the timing and severity of the ultimate amount of CBI claims to be a risk to the financial profile over the outlook horizon. Santam's business profile remains solid and anchors the ratings at current levels.

Santam's very strong competitive position is a significant credit positive. The insurer holds leading market positions on multiple strategic business units ("SBU') and products. In GCR's view, market share is likely to be maintained above 23% of short-term industry gross premiums and relative market share is projected to trend comfortably above 6x, supported by a multi-faceted business sourcing approach. Gross premium growth is expected to soften to around 4% (10M F20: 4%; 1H F20: 7.3%) in FY20 moderated by policyholder premium relief payments and dampened product demand, albeit likely to be fairly aligned with wider market trends. Growth is expected to be driven by direct business and inroads on specialist risks, leveraging off the Saham network, offsetting pressured intermediated products. In this regard, GCR sees sufficient traction within the majority of Santam's business segments to improve growth slightly in FY21.

Premium diversification is a further rating strength. Risks assumed by various SBUs support a business mix that covers more than six products with significant scale, led by property and motor, which constituted 33% and 37% of gross premiums in FY19, respectively. Geographic diversification is considered to be fair, with gross premium concentration to South Africa balanced by the granularity of external markets exposures through SEM participations and the Saham network. Overall, the diverse business structure is considered sufficiently entrenched to overcome short term risks and support stable earnings flows over the medium to longer term.

Diversified risk exposures and business scale benefit Santam's earnings, as reflected by stable historical profit margin trends, as well as a level of resilience to high value losses due to sound reinsurance protection. The insurer registered a consistent through-the-cycle underwriting margin of 7.0% over the review period, with metrics well contained within the 4% to 8% target range, supported by a total expense ratio consistently below 32%. However, elevated provisions on CBI claims depressed the insurer's 1H F20 underwriting margin to 2.8%, following the raising of R1.3bn reserves. A further R1.7bn was raised on CBI claims in 11M F20, potentially suppressing the underwriting margin to a 0% to 3% range and return on revenue (excluding once-off impairments) to between 6% and 8% (review period average: 10.3%) in FY20 under GCR projections.

Solid internal capital generation supports Santam's capitalisation assessment, with capital having increased by a five-year compound annual growth rate of 6.2% to R10.1bn at FY19 after paying 66% of earnings as dividends on average. Management's decision to suspend the 1H F20 dividend and improved profit generation in 2H F20 moderated recent pressure on retained earnings somewhat, with the internal economic model ("EIC") solvency capital requirement ("SCR") coverage ratio having been maintained near the lower boundary of the 150% to 170% target range (FY19: 160%; 1H F20: 150%) at 10M F20 (after accounting for the additional R1.7bn CBI provisions). This was supported by the containment of risk exposures and good access to capital markets among other capital management strategies. However, EIC and regulatory SCR coverage ratios could measure below a rating adequate range under a more severe claims scenario, which has been factored into the Negative Outlook. Furthermore, GCR considers the quality of capital as a slight restraint to the ratings, with Tier II capital accounting for 17% of total capital at FY19 and projected to rise to around 20% at FY20.

Liquidity is assessed within a moderately weak range. Cash and stressed assets coverage of net technical liabilities equated to a stable 1x, while operational cash coverage ranged between 8 to 10 months. Going forward, GCR expects liquidity metrics to measure within a 1x to 1.2x range over the medium term, despite possible elevated claims payments in FY21, taking into account strong operating cash flow generation and sound asset liability matching. Furthermore, the recent R1bn issue of subordinated debt as well as other cash preservation measures could mitigate downside risks to liquidity over the short to medium term.

Santam's ratings derive upliftment from implied parental support, given its relevance to the Sanlam Limited group, history of performance, and contribution towards group earnings diversification.

The negative one notch spread on the national scale long-term issuer credit rating reflects the regulatory subordination of senior unsecured creditors to policyholders. A further negative two notch spread on the notes reflects the subordinated status and mandatory deferability of the notes (if there is a Regulatory Deficiency Redemption or Interest Deferral Event).

## Outlook statement

The Negative Outlook reflects the potential for earnings capacity to moderate if further material reserves are raised in FY21, resulting in profit margins underperforming expectations, with volatility likely to increase above levels factored into the current assessment. Furthermore, liquidity and solvency metrics show limited tolerance to downside risks at current rating levels, especially given the potential increase in the contribution of Tier II capital to basic own funds. That said, GCR notes risk mitigation on liquidity and capitalisation metrics through various capital management strategies.

## Rating triggers

The Outlook could revert to Stable if earnings capacity reverts to historical levels, supporting risk adjusted capitalisation and liquidity metrics within the current range. GCR could lower the ratings upon one or several of the following materialising: (a) earnings displaying potential to measure below expectations over the medium term; (b) the group's regulatory solvency capital requirements coverage falling below 100% or EIC SCR coverage falling significantly below 150%, with limited near term recovery prospects; and (c) cash and stressed assets coverage of net technical liabilities measuring below 1x.

## Analytical contacts


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|---|---|---|
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## Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Insurance Companies, May 2019
GCR Ratings Scales, Symbols & Definitions, May 2019
GCR Country Risk Scores, November 2020
GCR Insurance Sector Risk Scores, July 2020

## Ratings history

| Rated Entity / Issue | Rating class | Review | Rating scale | Rating | Outlook/Watch | Date |
|---|---|---|---|---|---|---|
| Santam Limited | Financial strength | Initial* | National | AAA(ZA) | Stable Outlook | May 2009 |
| | | Last | | AAA(ZA) | Negative Outlook | August 2020 |
| | Financial strength | Initial* | International | A- | Stable Outlook | July 2013 |
| | | Last | | BB+ | Negative Outlook | August 2020 |
| | Long term issuer | Initial/last | National | AA+(ZA) | Stable Outlook | November 2019 |
| | | Last | | AA+(ZA | Negative Outlook | August 2020 |
| SNT02** | Long term issue | Initial | National | AA-(ZA) | Stable Outlook | November 2019 |
| | | Last | | AA-(ZA) | Negative Outlook | August 2020 |
| SNT03** | Long term issue | Initial | National | AA-(ZA) | Stable Outlook | November 2019 |
| | | Last | | AA-(ZA) | Negative Outlook | August 2020 |
| SNT04** | Long term issue | Initial | National | AA-(ZA) | Stable Outlook | November 2019 |
| | | Last | | AA-(ZA) | Negative Outlook | August 2020 |

*Formerly claims paying ability.
** Ratings were not accorded to individual notes prior to November 2019.

## Risk score summary

| Rating components and factors | Risk score |
|---|---|
| **Operating environment** | **14.00** |
| Country risk score | 6.50 |
| Sector risk score | 7.50 |
| **Business profile** | **3.25** |
| Competitive position | 1.50 |
| Premium diversification | 1.75 |
| Management and governance | 0.00 |
| **Financial profile** | **(0.50)** |
| Earnings | 0.75 |
| Capitalisation | (0.25) |
| Liquidity | (1.00) |
| **Comparative profile** | **1.00** |
| Group support | 1.00 |
| Peer analysis | 0.00 |
| **Total score** | **17.75** |

## Glossary

| | |
|---|---|
| Assets | A resource with economic value that a company owns or controls with the expectation that it will provide future benefit. |
| Capital | The sum of money that is invested to generate proceeds. |
| Capitalisation | The provision of capital for a company, or the conversion of income or assets into capital. |
| Claim | A request for payment of a loss, which may come under the terms of an insurance contract. |
| Credit Rating | An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories. |
| Debt | An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period. |
| Distribution Channel | The method utilised by the insurance company to sell its products to policyholders. |
| Gearing | Gearing (or leverage) refers to the extent to which a company is funded by debt and can be calculated by dividing its debt by shareholders' funds or by EBITDA. |
| International Scale Rating LC | International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions. |
| Liquidity | The speed at which assets can be converted to cash. The ability of an insurer to convert its assets into cash to pay claims if necessary. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price. |
| Premium | The price of insurance protection for a specified risk for a specified period of time. |
| Rating Horizon | The rating outlook period |
| Statutory | Required by or having to do with law or statute. |
| Subordinated Debt | Debt that in the event of a default is repaid only after senior obligations have been repaid. It is higher risk than senior debt. |
| Underwriting Margin | Measures efficiency of underwriting and expense management processes. |

## SALIENT POINTS OF ACCORDED RATINGS

GCR affirms that a.) no part of the rating process was influenced by any other business activities of the credit rating agency; b.) the ratings were based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings are an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit ratings have been disclosed to the rated entity. The ratings above were solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the ratings. The rated entity participated in the rating process via virtual management meetings, and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible. The information received from Santam Limited and other reliable third parties to accord the credit ratings included:

- The audited financial statements to 31 December 2019;
- Four years of comparative audited financial statements to 31 December;
- Unaudited interim results to 31 October 2020;
- Budgeted and forecast financial statements to 31 December 2020;
- Santam group and company Own Risk and Solvency Assessment Report to 31 December 2019;
- Santam Solo Statutory return to 30 June 2020; and
- Other related documents.

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